Forecast

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Though the Indian economy recorded seven per cent growth in the last quarter of 2004-05 (up from 6.4 per cent during the third quarter of the same year), it failed to match the 8.4 per cent growth recorded in the last quarter of 2003-04. Annual growth during 2004-05 was pegged at 6.9 per cent by the Central Statistical Organization (CSO), against 8.5 per cent achieved the previous fiscal. Agriculture performance has been the main spoilsport. While the performance of sectors like manufacturing, construction, trade, hotels and restaurants, transport, storage and communication and finance, insurance and real estate all contributed to first quarter growth, low growth in agriculture, and mining and quarrying had an adverse impact.

The Current Scene

The monsoon is improving now, albeit after a bit of uncertainly leading to apprehensions of a major setback in agricultural growth after the dismal performance last year. The India Meteorological Department's (IMD) forecast, released on July 6, projects a near normal monsoon this year.

After the initial delay, the monsoon promises to be rather good. However, the flipside of heavy downpour is flooding in some parts of the country which has in the past caused cropping difficulties. Flooding also creates temporary market access bottlenecks that cause prices of agro products, in the main, to go up in some major markets.

It seems that interest rates will remain benign for some more time. Thus the non-food credit offtake is unlikelt to go down. It has remained healthy so far and the sustained growth of demand for industrial products is linked to this. There has been a very high rise in the demand for household credit in the form of consumer credit and housing finance. This could have offset the poor demand from the agricultural sector last fiscal. The improving performance of the financial sector has helped the economy during the current situation, by providing innovative deals to consumers for purchasing durables and properties.

Index of industrial production (IIP) numbers show a good performance thus far by the industrial sector (IIP in consumer durables during 2004-05 experienced a growth of 14.3 per cent over the previous year). The growth in IIP for non-durables has also been very healthy.

Non-food credit offtake has remained healthy so far

The environment created by the Budget is expected to have a positive impact on industrial performance. The policies have attempted to encourage investment through incentives provided for improved FDI inflows. The boost to infrastructure will also help. Monetary policy promises continuous efforts for providing adequate liquidity to meet credit growth. The goal is not to constrain exports and investment, the two important drivers of our economy at present.

The external sector is less positive. The strengthening of the rupee vis-à-vis the US dollar could become a problem

However, the external sector is less positive. Though at present exports are performing well, the continuous strengthening of the rupee vis-à-vis the US dollar could become a problem. The other important factor is the volatility of oil prices. The new highs could set off inflationary tendencies both internationally and domestically. High oil prices would also dampen the fast growing Chinese economy, and could lead to higher trade protection in developed countries.

The global economy is experiencing a slowdown and the rejection of the constitutional treaty in France and the Netherlands has caused concern about Europe's economic performance in coming years. There is also the ongoing concern regarding the huge US current-account deficit, and few hold out hope of the dollar hardening during 2005-06. At the same time, the US is also hardening its interest rates, which would impact the global economy adversely: hurting emerging economies and also impacting final demand adversely.

Leading Indicators

In the absence of monthly data on GDP to reflect the state of the economy, the Index of Industrial Production-Manufacturing (IIPM) could be taken as a coincident indicator for the economy. A series of IIPM are chosen over other indicators such as employment, income, etc., which also are important in gauging the health of an economy. This is mainly because employment and income data are not available on a monthly basis. Moreover, it has been observed that the turning points of the cyclical component of IIPM obtained by removing trend, seasonal and the random components from the series, coincide with almost all the turning points of the GDP. Although IIPM does not capture all levels of economic activities, it does act as an effective proxy in the absence of more comprehensive measures available on a monthly basis.

A time series of economic variables, which tend to reach the turning point before the corresponding turning point in the coincident indicator, is called a 'leading indicator.' The indicators are measures of different aspects of present economic activity. The monetary variables are very closely related to current economic activity trends and the cyclical components of monetary variables are well harmonised with coincident indicators. The cyclical components have been increasing for the last three or four months for all the monetary variables such as bank-credit, credit deposit ratio, bank credit to commercial sector and non-food credit (Table F.1). However, currency with the public has experienced a downtrend since January 2005. The upturn in most of the monetary variables restores confidence in ongoing economic activities. This is also cor-

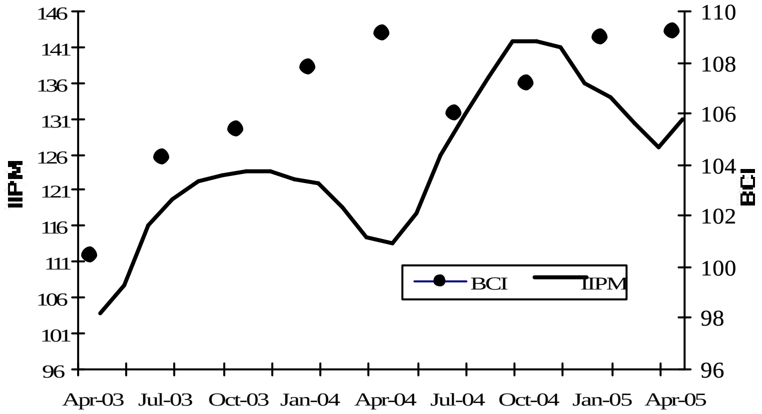
Table F.1: Growth in the Cyclical Component of Selected Leading Indicators (Over the Previous Month %)

Months	Bank Credit (Rs.crore)	Bank Credit to Commercial Sector (Rs.crore)	Credit Deposit Ratio	Currency with the Public (Rs.crore)	Non Food Credit (Rs.crore)	NON POL Imports in Dollar terms	Production of Commercial Vehicles ('000)	Production of Cement ('000 Tonnes)	BSE Sensex Index
Apr-04	0.6	0.2	0.6	-1.0	0.7	2.4	2.0	-1.1	-4.0
May-04	1.1	0.5	0.8	-0.6	1.4	10.1	9.6	0.7	-2.6
Jun-04	0.2	0.3	1.1	0.0	0.7	-8.7	1.7	-1.8	-0.1
Jul-04	1.4	1.2	1.5	1.0	1.4	-10.3	-2.4	-2.6	2.5
Aug-04	1.1	0.6	1.8	1.3	1.0	-2.2	-2.8	3.1	3.1
Sep-04	2.5	1.8	3.0	-0.1	2.7	13.2	-2.0	1.8	2.2
Oct-04	1.6	1.5	2.5	0.4	1.8	7.2	2.1	4.9	8.0
Nov-04	1.8	1.1	1.5	-0.3	2.0	13.8	2.6	-0.9	9.5
Dec-04	-0.3	-0.2	-0.4	0.6	-0.3	3.4	2.2	-1.6	5.6
Jan-05	-0.5	-0.4	-0.9	-0.7	-0.4	8.3	2.7	-2.9	0.9
Feb-05	-1.0	0.1	-0.1	-0.2	-0.9	-12.7	-2.3	-2.9	-3.3
Mar-05	0.8	0.6	0.1	-0.4	0.9	8.6	-4.5	1.9	-3.7
Apr-05	1.2	0.9	1.1	-0.4	1.6	5.8	0.2	-0.5	1.7
May-05	1.8	1.0	1.1	-0.4	2.2	12.6	-	-	6.4

roborated by growth in real terms. Among other leading indicators, the cyclical component of non-POL imports (dollar terms) also has been on an upward swing. Further, the cyclical component of the BSE-sensex has turned upward in April 2005 after continuously falling in the previous three months (Fig F.2). In real terms, the growth in the BSE-sensex (which experienced a double digit growth continuously since June 2003) fell below nine per cent in April 2005 but again jumped back to 41.1 and 50 per cent growth in May and June 2005 respectively. However, the cyclical component of a leading indicator, the production of commercial vehicles, has been moving in a downward direction continuously since January 2005. In real terms, the production of commercial vehicles experienced a negative growth of five per cent in April 2005.

An important leading indicator for the economy has been the business confidence index (BCI) constructed by the National Council of Applied Economic Research (NCAER) (Fig F.1). The BCI has been tracking the turning points in IIPM in most cases. The BCI for April 2005 touched a new peak at 143.1, crossing the previous high of 142.8 in April 2004. The four components of the BCI, namely, overall economic condition, financial position of firms, investment climate and capacity utilisation reflect a different dimension of confidence in the business community. In the last two rounds, all four components moved up together. However, this trend broke with the two dimensions representing the individual firm's experience, financial position and capacity utilisation by moving downwards in April 2005. The overall economic condition and investment climate (representing the macro level dimension of the business community) began its rising trend in October 2004, which continued in April 2005.

Fig F.1: Business Confidence Index with the Cyclical Component of IIPM



Forecast for 2005-06

The current forecast has been prepared taking into consideration the current domestic and global developments affecting the Indian economy.

The major driving force behind this forecast is the combination of four factors, viz. the monsoon, rising oil prices, a dampening of the world economy and a positive domestic investment climate.

As discussed in the agricultural section in this review, though there has been a revival of the monsoon, there have also been delays and erratic rainfall. Flooding in different parts of the country has caused difficulties in transportation, leading to a shortfall of supplies in different mandies and causing inflationary tendencies in agro- products.

While carrying out the forecasting exercise, the basic assumptions relating to the tax rate changes and government consumption and investment expenditure remain the same as in the last forecast. However, the current situation and the information that has become available now led to the revision of the April forecast on the basis of changed assumptions.

The key assumptions which are different in the July forecast compared to the April forecast are:

- Agricultural production to rise by 2.5 per cent as compared to 3.5 per cent assumed in April this year.
- Agricultural prices to rise by six per cent compared to 5.5 per cent assumed in the earlier forecast.

- World GDP growth of 3.1 per cent compared to 4.3 per cent assumed in the April forecast.
- World prices to rise by 5.5 per cent compared five per cent in the earlier forecast.
- Oil prices rise by 18 per cent.
- A 25-basis-point increase in interest rates.

Our July GDP forecast is marginally lower at 7.05 per cent, compared to 7.2 percent projection made in April (Table F.2).

The decline in agricultural production to 2.5 per cent from 3.5 per cent causes demand to contract, resulting in a deceleration in GDP growth. At the same time, the rise in agricultural and oil prices generate a supply side push for industry to increase production. Industry experiences a growth of 7.5 per cent in this forecast, which is only marginally lower than the earlier forecast. There has also been no adverse impact on services, which are projected to grow by 8.6 per cent as in the earlier forecast.

In case of world trade again there are opposing forces. The fall in World GDP causes a dampening in export growth. However, as world prices are expected to rise, export growth is marginally lower at 20.6 per cent compared to 20.9 per cent projected in the earlier forecast.

Lower GDP also impacts import growth negatively. However, the higher domestic prices relative to world prices push imports to higher growth. As a result imports grow by 24.5 per cent compared to 23.9 per cent that was projected earlier. This results in higher trade deficit. Moreover the current account deficit also remains marginally positive.

With lower GDP, the fiscal deficit is projected to be somewhat higher than that projected in the last forecast.

However, buoyancy in industrial production, together with the rise in prices, curbs the deficit, which is projected to be 4.12 per cent compared to four per cent projected in April 2005.

Our July GDP forecast is marginally lower at 7.05 per cent, compared to the 7.2 percent projection made in April

Table F.2: Alternative Projections of Key Macro Variables: 2004-05

Variables	Unit	2004-05 Official	2005-06 April	2005-06 July
Real GDP	Rs Crore	1529408	7.19	7.05
Agriculture	Rs Crore	314180	3.30	2.50
Industry	Rs Crore	413760	7.61	7.54
Service	Rs Crore	801468	8.55	8.55
INVESTMENT				
Public	Rs Crore	164747#	12.50	12.50
Private	Rs Crore	462560#	12.00	12.20
EXPORTS	Billion $	79.6	20.89	20.63
IMPORTS	Billion $	106.1	23.87	24.54
Average Price	%	6.47	6.30	6.50
	As % of GDPMP			
Fiscal Deficit of the Centre	%	4.11	4.01	4.12
TD	%	3.84	2.21	2.28
CAD	%	1.76	0.24	0.25

2003-04